Assurance — Week 7 Practice Case

Solution

The following solution is a “best” response, demonstrating a level much higher than competent. However, there may be additional acceptable and reasonable points that are not reflected in this response.

In addition, candidates are not expected to prepare a response of this level given the time constraints involved and, if applicable, page limits provided.

Assessment Opportunity #1

The candidate discusses the classification issue related to the housing loan receivable.

The candidate demonstrates competence in Financial Reporting.

CPA Map Competencies:

1.2.2 Evaluates treatment for routine transactions (Core – Level A)

Housing loan receivable

Issue

The employee loan receivable balance is classified as current. The issue is whether it is appropriate to classify the full receivable as current, or if the receivable belongs as a long-term asset.

Handbook and analysis

Per IFRS (IAS 1 *Presentation of Financial Statements*), only the portion that will be realized within 12 months after the date of the statement of financial position should be classified as current. The CFO has argued that the loans are demand loans and therefore should be considered current. Our examination of a standard agreement indicates that the loans are repayable over a 15-year period and only become demand loans once the employee leaves the company. Therefore, only the loan payments that will become receivable by BC during the next year can be considered current.

Recommendation

Based on our analysis of the receivable, only $^{1}/_{15}$ of the amount should be included as current, plus the amount owed by the retired employee and any other employees who are no longer with the company.

The remainder must be shown as a long-term asset.

See Appendix I for financial statement impact and Appendix II for bank covenant impact.

Assessment Opportunity #2

The candidate discusses the potential impairment of the retiree's housing loan receivable.

The candidate demonstrates competence in Financial Reporting.

CPA Map Competencies:

1.2.2 Evaluates treatment for routine transactions (Core – Level A)

Impairment of retiree's housing loan

Issue

The employee loans receivable, including the housing loan receivable from the retired employee, are recorded at their face value. The issue is that loans receivable should be recorded net of the expected credit losses.

Handbook and analysis

Loans receivable should be recorded in accordance with IFRS 9 *Financial Instruments* net of an allowance for expected credit losses. According to IFRS 9, when measuring expected credit losses, an entity shall consider the risk or probability that a credit loss occurs by analyzing the possibility that a credit loss occurs and the possibility that no credit loss occurs, even if the possibility of a credit loss occurring is very low.

IFRS 9.5.5.3 states:

> *At each reporting date, an entity shall measure the loss allowance for a financial instrument at an amount equal to the lifetime expected credit losses if the credit risk on that financial instrument has increased significantly since initial recognition.*

In contrast, IFRS 9.5.5.5 indicates that where the credit risk on a financial instrument has not increased significantly since initial recognition, the loss allowance should be an amount equal to *12-month expected credit losses*.

It appears that the credit risk on the loan from the retired employee has increased significantly, given the following:

- The employee has not repaid any amount of the loan since year end.
- The employee no longer works for BC and therefore is likely to have difficulty repaying the loan.

Based on this analysis, an allowance equal to the lifetime expected credit losses on the employee receivable for the retired employee should be recognized.

Recommendation

It appears highly probable that no money will be collected from the retiree and therefore the allowance for expected credit losses should reflect the full amount of that receivable. I will need more information on the remaining employee receivable balances to determine the probability of a credit loss occurring in order quantify the additional allowance required.

See Appendix I for financial statement impact and Appendix II for bank covenant impact.

Assessment Opportunity #3

The candidate discusses the inventory valuation issue related to the foundation process inventory.

The candidate demonstrates competence in Financial Reporting.

CPA Map Competencies:

1.2.2 Evaluates treatment for routine transactions (Core – Level A)

Foundation process inventory

Issue

BC purchased $1.25 million of foundation process materials that it planned to use on the construction of a multi-unit housing project in NL. However, BC has yet to receive full regulatory approval for the foundation process in NL. If it cannot use the inventory in NL, it can use it in BC. The issue is whether the inventory has been valued at the right amount.

Handbook and analysis

IAS 2 *Inventories,* paragraph 9, states, “inventory should be measured at the lower of the cost and net realizable value,” and paragraph 10 states, “the cost of inventory should include all costs of purchase, costs of conversion, and other costs incurred in bringing the inventories to their present location and condition.”

BC has already received a letter from an NL engineer who inspected the design of the project and questioned the quality of BC’s foundation process for the NL climate. Therefore, it is questionable whether BC will receive regulatory approval in NL. However, if BC does not receive NL approval, it can use the foundation materials on a BC construction project, as the foundation process has already been approved in BC. Therefore, it does not appear that the net realizable value would be lower than the cost. However, BC may have to ship those materials back to BC and incur additional transportation fees to make the materials usable, which would be an inventory cost.

Recommendation

If inventory cannot be used in NL, add the additional costs of bringing the inventory to BC to the inventory cost, to the extent that the aggregate inventory costs are less than the net realizable value of the inventory (that is, are recoverable).

I could not quantify the impact to the financial statements, but this may increase the amount recorded as inventory and may positively impact the bank covenant.

Assessment Opportunity #4

The candidate summarizes the unadjusted misstatements found during the audit and advises the partner regarding the overall effect on the financial statements and the auditor’s report.

The candidate demonstrates competence in Audit and Assurance.

CPA Map Competencies:

4.3.8 Evaluates the evidence and results of analysis (Elective – Level A)
4.3.10 Draws conclusions and communicates results (Elective – Level A)
4.3.11 Prepares or interprets information and reports for stakeholders (Elective – Level B)

Summary of misstatements

I have prepared a summary of misstatements (Appendix I) that shows the overall effect of the identified misstatements I have discussed on the financial statements. There is also a transposition error affecting accounts receivable.

Per CAS 450.8, (CAS 450 *Evaluation of misstatements identified during the audit),* we must request that management adjust all accumulated misstatements. Given that the CFO is adamant about not making adjustments, it is possible that he will refuse to make them. In this case, we should ask those charged with governance to adjust them, as per CAS 450.12. The accumulated errors are material, and therefore the financial statements will have to be adjusted to be free from material misstatement.

Impact on audit opinion

To provide an unqualified audit opinion, some misstatements must be booked because the total assets and net income are overstated by $312,960 (Appendix I), which is greater than our materiality of $272,500. Therefore, if no adjustments are made, the financial statements would be materially misstated and would be misleading to the users (especially the bank, given its reliance on the financial statements for the covenant calculation).

The misstatement does not relate to an inability to obtain sufficient and appropriate audit evidence, and we are aware of the impact of the identified misstatements. Therefore, we would not issue a disclaimer of opinion.

Reporting options would include a qualified opinion or an adverse opinion. An adverse opinion would be appropriate if the financial statements are misleading or virtually useless even when read in conjunction with our audit report.

A qualified opinion would be justified if we are comfortable that we can express a positive opinion on the financial statements as a whole and can fully disclose in our report the reasons for the qualification. In this situation, because we are certain of the effects of the misstatements, we can issue a qualified opinion. The bank would be able to adjust the statements based on the exceptions noted in the auditor’s report.

If BC wants a clean audit report, it must address the issues we’ve highlighted and make the required entries.

Impact on bank covenant

The bank requirements have been recalculated in Appendix II. When unadjusted numbers are used, the working capital ratio is 1.37. However, when the misstatements are corrected, the working capital ratio becomes 1.29 and BC is in breach of the bank covenant. Also note that when adjusted asset numbers are used, BC’s operating line limit is $30,241,138. BC has drawn $30,200,000 at year end; it is still within its limit but getting close. Therefore, it should be monitored.

The client should communicate this breach to the bank right away and present an action plan to show that it is able to repay the loan.

If the loan is called, the bank could act on its General Security Agreement on the assets of BC and could put the company into bankruptcy. This would affect our assessment of the ability to continue as a going concern; we are required to make this assessment in accordance with IAS 1.

If a going concern note is required and is adequately added to the note disclosure by management, we are permitted per CAS 570 *Going Concern,* paragraph 22 to express an unmodified opinion (in relation to this item) and must include an Emphasis of Matter paragraph in the auditor's report, highlighting the existence of the going concern issue and drawing attention to the going concern note in the financial statements.

Assessment Opportunity #5

The candidate raises issues to include in management's letter to the client.

The candidate demonstrates competence in Audit and Assurance.

CPA Map Competencies:

4.1.1 Assesses the entity's risk assessment processes (Elective – Level A)

During our audit, we noted some deficiencies in internal control. In most cases, the control deficiencies did not impact the audit results. However, we believe that management should address these issues before more serious control breakdowns occur. In addition, we noted circumstances in which BC appears to lack a set policy to address situations that occurred during the year. As a result, we have suggested policies that would improve the general control environment.

Employee housing loans

Weakness: BC has granted employee housing loans to 110 employees, amounting to close to $4 million in loans. When the loans were granted, the CFO did not obtain security for them as he felt the paperwork would be too time-consuming.

Implication: BC now has $4 million in assets (in the form of employee receivables) that are at risk because they are not secured. Impairment will be a risk going forward.

Recommendation: In the future, all employee housing loans should be secured.

Segregation of duties

Weakness: In the latter part of the year, one individual was creating purchase orders, entering invoices into the system, and preparing the cheque runs. These are incompatible duties. This was due to the controller role being vacant.

Implication: The individual could purchase from a fictitious supplier and then create a cheque to pay that supplier. Segregation of duties in the purchasing cycle is imperative for safeguarding the assets of the company.

Recommendation: BC should hire a new controller and ensure that staffing is at a level such that incompatible duties are segregated.

Secondary review of journal entries

Weakness: Members of the finance department do not do a secondary review of journal entries made to the accounting system.

Implication: A review is necessary to ensure that the risk of misstatement from improper coding or dollar value amount is minimized. Misstatements could have an impact on financial reporting and construction costing reports, which may be detrimental to the company and could cause improper business decisions to be made.

Recommendation: Appropriate personnel should review all journal entries to ensure the accuracy of the entries and the resulting financial information.

Management review of costing reports

Weakness: Our investigation regarding management review of reports indicated that, although reports were eventually reviewed, the review of certain reports was not timely.

Implication: Timely review of reports is vital to ensuring that the financial information on which the reports are based is accurate. Accuracy of financial information is required to make sound business decisions and for sound fiscal management.

Recommendation: Ensure that timely management review of financial information occurs.

Material sign-out sheets

Weakness: Our test count of inventory noted discrepancies. The CFO said that employees are not completing the sign-out sheet for materials.

Implication: Materials may not be charged to the right projects, or materials could be stolen and employees could hide the theft by charging it to a job.

Recommendation: Ensure that employees are completing the sign-out sheets for material used, and that these are reconciled to the project costs.

Assessment Opportunity #6

The candidate discusses why some of BC's strategies and the actions of the CFO may have been detrimental to BC.

The candidate demonstrates competence in Strategy and Governance.

CPA Map Competencies:

2.1.1 Evaluates the entity's governance structure (Elective – Level B)

It appears that BC has made some poor management decisions in the last few months. BC's recent expansion into NL does not appear to be going as well as planned and risks being a cash drain on the company.

In addition, BC has implemented two programs, the "Walk a Mile in Your Co-Worker's Shoes" program and the Employee Housing Loans Program, which seem to be causing more harm than good.

In all these cases, management made decisions that are costing BC money without achieving the intended objectives. Management needs to re-evaluate each of these decisions and, if necessary, put an end to the programs. Management should also be stepping back and assessing why the objectives were not achieved so they can prevent similar errors from occurring again in the future.

Expansion into NL

Even though BC still shows a profit, its overall profitability has declined. Per discussion with senior management, gross margins have decreased, bad debts have increased, and operating costs have increased due to the expansion to NL. Furthermore, inventory levels have increased substantially, which ties up limited operating capital. The effects on the financial situation are evident in the current fiscal year and appear to be the direct result of management's expansion decision, which may have been made in haste in an attempt to take advantage of the "booming" NL market.

Considering that the NL construction market is now saturated with contractors and the credit situation is deteriorating, it is difficult to imagine that highly profitable contracts will be found. While it may be possible that the NL situation will improve, it is an unknown. Continued presence in this market is questionable and further expansion should be approached with caution.

Walk a Mile in Your Co-Worker's Shoes

During the past year, in an effort to encourage teamwork among management, senior management embarked on a program known as "Walk a Mile in Your Co-Worker's

Shoes." While the program may be beneficial for BC's employees, it appears that it may be causing mistakes to occur, which could cost the company.

While conducting our audit, we noticed that errors were made because personnel were performing tasks for which they were not trained. For example, while acting in the capacity of the purchasing manager, a construction manager erroneously ordered $900,000 in inventory. While the inventory will be used, it will tie up limited and valuable financial resources in the interim. Such unnecessary use of funds puts undue pressure on the company's financial resources. In addition, it appears that certain personnel are unable to perform their own duties because they spent time learning new responsibilities. Management review and monitoring of the financial status of projects is vital to the overall financial well-being of BC. If managers are busy learning new duties and are unable to monitor a project they are responsible for, the financial success of the project may be in jeopardy.

Management should reconsider the program and perhaps design alternative strategies to enhance teamwork and effectiveness. For example, vertical intra-departmental cross-training, rather than horizontal inter-departmental cross-training, may alleviate concerns associated with duty coverage. Personnel within a certain department would be more inclined to learn other duties associated with their own interests rather than the duties of another department.

Employee housing loans

In another new initiative, presumably to incentivize staff, management offered no-interest housing loans to employees. This effort has a direct financial impact on BC. The loans have been financed by BC's operating line. Per review of the financial statements and as discussed above, the operating line is nearing its limit, largely due to the almost $4 million in employee housing loans.

CFO's behaviour

I believe that the CFO has demonstrated indifferent behaviour and, in doing so, has put BC at risk. The following incidents illustrate the CFO's behaviour, and they should be brought to the board's attention.

1. The CFO neglected to obtain security on the employee housing loans for all the wrong reasons. The CFO did consider obtaining security for the loans but did not want to deal with the paperwork involved. As a result, the CFO has put the $4 million in loans that BC granted at risk.

2. The CFO has adamantly refused to make adjustments to the financial statements, thereby potentially rendering them misleading to users.

Appendix I
Summary of possible misstatements

Purpose: To aggregate the estimated identified errors to assess whether a material misstatement exists and to facilitate a check of the compliance with the bank covenant.

Materiality $272,500 Performance materiality $177,125

	Description	Current assets	Current liabilities	Working capital	Total assets	Total liabilities	Pre-tax income
Note 1	Transposition error	$ (277,560)	—	$ (277,560)	$(277,560)	—	$(277,560)
Note 2	Reclassification of LT portion of loans receivable	$(3,543,493)	—	$(3,543,493)	—	—	—
Note 3	Impairment of retiree's loan — current portion	$ (35,400)	—	$ (35,400)	$ (35,400)	—	$ (35,400)
Note 4	Foundation process inventory	?	—	?	?	—	—
	Misstatements identified in the period	$(3,856,453)	—	$(3,856,453)	$(312,960)	—	$(312,960)
	Misstatements uncorrected from prior periods	—	—	—	—	—	—
	Total misstatements discussed with management	$(3,856,453)	—	$(3,856,453)	$(312,960)	—	$(312,960)
	Less: misstatements corrected by management	—	—	—	—	—	—
	Aggregate of uncorrected misstatements	$(3,856,453)	—	$(3,856,453)	$(312,960)	—	$(312,960)

Conclusion: The aggregated errors indicate a material misstatement on net income, since materiality is $272,500.

Appendix I (continued)

Notes

1. A progress billing error was made where a completion rate of 86% was used instead of 68%. However, we will need to determine whether the same transposition error was made to the construction work-in-progress account, and whether that account will need an adjustment as well.

   = 18% × $1,542,000 = $277,560

2. Reclassification of long-term portion of employee loans receivable (before write-off of retiree's housing loan):

   Current portion = ($3,832,000 – $35,400) / 15 = $253,107 + $35,400 = $288,507
   Long-term portion = $3,832,000 – $288,507 = $3,543,493

3. Write-off of retiree's housing loan — $35,400 (all current).

4. Unable to estimate, but would also have a negative impact.

Appendix II
BC's bank requirements

Purpose: To calculate the operating line limit and working capital ratio before and after the adjusted misstatements to assess compliance with the bank requirements.

Operating line

	Account balance before adjustment	Transposition error (Note 1)	Retiree loan (Note 2)	Inventory (Note 3)	Account balance after adjustment	%	Operating line limit before adjustment	Operating line limit after adjustment
Accounts receivable	$20,100,000	$(277,560)			$19,822,440	80%	$16,080,000	$15,857,952
Employee receivable	3,832,000		$(3,578,893)		253,107	80%	3,065,600	202,486
Inventory	9,255,000			?	9,255,000	50%	4,627,500	4,627,500
Construction in progress	31,844,000	?		?	31,844,000	30%	9,553,200	9,553,200
	$65,031,000	$(277,560)	$(3,578,893)	?	$61,174,547		$33,326,300	$30,241,138

Working capital (target = 1.35)

W/C ratio = Current assets / Current liabilities

Before adj. $65,031,000 / $47,543,000 = 1.37

After adj. $61,171,547 / $47,543,000 = 1.29

Appendix II (continued)

Notes

1. A progress billing error was made where a completion rate of 86% was used instead of 68%. However, we will need to determine whether the same transposition error was made to the construction work-in-progress account, and whether that account will need an adjustment as well.

   = 18% × $1,542,000 = $277,560

2. Reclassification of long-term portion of employee loans receivable and write-off of retiree's housing loan:

   Long-term portion = $3,832,000 – $288,507 = $3,543,493
   Write-off of retiree's housing loan: $35,400
   Total adjustment= $3,543,493 + $35,400 = $3,578,893

3. Unable to estimate the inventory and the construction in progress.

Conclusion: The working capital ratio and operating line limit are met before adjustments. However, the working capital ratio is breached after adjustments, which will require BC to discuss the situation with the bank to prevent the loan from being called. The operating line is still under the limit but is very close. Therefore, it should be closely monitored.